



DEFENSE CONTRACT AUDIT AGENCY
DEPARTMENT OF DEFENSE
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IN REPLY REFER TO

PQA 720.7.A.

November 1, 2005
05-PQA-066(R)

MEMORANDUM FOR REGIONAL DIRECTORS, DCAA
DIRECTOR, FIELD DETACHMENT, DCAA

SUBJECT: Audit Guidance on Documenting the Understanding of Internal Controls for Contractors With Less Than \$15 Million Annual Dollar Volume (ADV)

Summary

This memorandum is being issued to provide examples of working paper (W/P) B-2, Section 1, "Review of Internal Controls and Assessment of Control Risk", (Enclosures) to illustrate the documentation necessary to support the auditor's understanding of internal controls at contractors with less than \$15 million of annual dollar volume (ADV).

Background

In MRD 05-PQA-045(R), dated June 28, 2005, we provided key results of the FY 2005 PCIE-based review on incurred cost audits, along with related audit guidance to address areas needing improvement. (The complete results of the PCIE-based review can be found on the DCAA intranet at the Policy Quality Assurance web page under "PCIE-based reviews.") As stated in MRD 05-PQA-045(R), auditors are required to document their understanding of contractor internal controls in every audit performed in accordance with the Government Auditing Standards. This step is required even when control risk is assessed as maximum (CAM 5-111.2). Generally, at smaller contractors, in lieu of testing internal controls, it is more efficient to assess control risk as maximum and perform the necessary level of substantive testing. For nonmajor contractors with ADV greater than \$15 million, documenting the understanding of internal controls should be accomplished by completing or reviewing and referencing a completed Internal Control Questionnaire (ICQ) (CAM 5-111.1). However, for examinations of contractors with less than \$15 million ADV, Agency guidance (CAM 5-111.1) allows the auditor to use a more simplified procedure than the completion of an ICQ to document the required understanding of the internal controls. For these examinations, auditors have the option of documenting their understanding in a narrative format, as described in CAM 10-504.6b. For desk reviews (as opposed to examinations) of low risk contractors less than \$15 million, these steps are not necessary.

Guidance

As enclosures to this memorandum, we have provided two W/P B-2, Section 1, examples for a nonmajor incurred cost audit to illustrate the documentation necessary to support an auditor's understanding of internal controls at contractors with less than \$15 million ADV when an ICQ is not completed. Enclosure 1 is an example where the FAO has limited previous audit experience

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with the contractor (e.g., no pre or post award accounting system review has been performed). Enclosure 2 is an example where the FAO has performed a pre or post review of the contractor's accounting system. The example working paper follows the guidance in CAM 5-111.1 by providing the following key minimum elements:

- A description (or reference to a description) of the methods used for accumulating and allocating indirect costs to Government contracts and other work of the contractor. Typically, this would consist of a listing of the various indirect cost pools with brief explanations of their composition and of the related bases for allocation. In lieu of providing a listing of indirect cost pools and bases, a specific reference to the contractor's disclosure statement, incurred cost submission, or other permanent file contractor document where the pools and bases are described is sufficient.
- If applicable, a conclusion of the impact on the current audit of any significant recent change in cost accounting practice disclosed by the contractor (e.g., Incurred Cost Submission, Schedule M.). The planned audit procedures should include reviewing any significant recent change in accounting practice (e.g., combining five indirect cost pools in to two).
- A brief description of the results of DCAA's audit of the contractor's accounting system. This should include the system opinion and any accounting system deficiencies outstanding during the year under audit and the status of any contractor corrective action.
- An explanation of (or reference to) the contractor's policies and procedures for identifying and segregating unallowable costs in the accounting records and excluding those costs and all directly associated costs from U.S. Government contract costing, billing, and pricing.

It should be noted that the examples provided are for illustrative purposes. Auditors are required to document their understanding of internal controls based on the specific contractor operations under audit.

Concluding Remarks

If FAO personnel have any questions, they should contact regional personnel. If regional personnel have any questions, they should contact Quality Assurance Division, at (703) 767-2250.

/s/ Terry M. Schneider
/for/ Earl J. Newman
Assistant Director
Policy and Plans

DISTRIBUTION: C

Enclosures: a/s

ABC Company
Arlington, VA

FY 2003 ABC Company Incurred Cost
REVIEW OF RELEVANT INTERNAL CONTROL DATA

1. Review of Internal Controls and Assessment of Control Risk

- a. *Review the Internal Control Questionnaire (ICQ) or other permanent file documents to gain an understanding of the relevant contractor systems for the year under audit. Document below completion of this step by providing specific reference to (or hyperlink) information reviewed. If completion of an ICQ is not required (CAM 5.111.1a) and the significant and relevant internal controls, if any, are not documented in the ICQ or permanent file, you must gain an understanding of these internal controls and document it briefly below. This documentation should include a reference to the contractor's policies and procedures, if any, for (1) identifying and segregating unallowable costs and directly associated costs, and (2) excluding such costs from incurred cost claims to the Government. If applicable internal controls have not been reviewed and sufficiently tested for operational effectiveness, control risk must be assessed at the maximum (CAM 5-102a and 5.111).*

We have not performed an audit of ABC Company's accounting system.

ABC Company uses a calendar year accounting period. ABC Company's procedures include maintaining a job order cost accounting system on an accrual basis in accordance with generally accepted accounting practices. The contractor's procedures also include (1) maintaining a chart of accounts in which specific accounts have been established for accumulating unallowable costs and directly associated costs (W/P B-2a) and (2) procedures for excluding these costs from submissions (e.g., proposals, billings and claims) to the Government.

ABC's indirect pools and bases established to accumulate and allocate indirect costs are as identified in its incurred cost claim on W/P 22, Schedule A and supporting schedules. The contractor has not identified any significant accounting changes (W/P 22, Schedule M).

√	Maximum Control Risk
Control risk is assessed at maximum because (i) it is more efficient to perform substantive testing than perform tests of internal controls or (ii) the internal controls are ineffective or nonexistent.	

	Below Maximum Control Risk
(Control risk can only be assessed below maximum if significant internal controls applicable to the CFY being audited have been reviewed and sufficiently tested for operational effectiveness. If control risk is assessed below maximum, document/reference below the audit assignment where the tests of controls were performed that supports the assessment.)	

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Auditor:	
Date:	

Enclosure 1

ABC Company
Arlington, VA

FY 2003 ABC Company Incurred Cost
REVIEW OF RELEVANT INTERNAL CONTROL DATA

1. Review of Internal Controls and Assessment of Control Risk

- a. *Review the Internal Control Questionnaire (ICQ) or other permanent file documents to gain an understanding of the relevant contractor systems for the year under audit. Document below completion of this step by providing specific reference to (or hyperlink) information reviewed. If completion of an ICQ is not required (CAM 5.111.1a) and the significant and relevant internal controls, if any, are not documented in the ICQ or permanent file, you must gain an understanding of these internal controls and document it briefly below. This documentation should include a reference to the contractor's policies and procedures, if any, for (1) identifying and segregating unallowable costs and directly associated costs, and (2) excluding such costs from incurred cost claims to the Government. If applicable internal controls have not been reviewed and sufficiently tested for operational effectiveness, control risk must be assessed at the maximum (CAM 5-102a and 5.111).*

ABC Company maintains a job order cost accounting system, which we consider acceptable for accumulating and billing costs incurred under Government cost-type prime contracts and subcontracts (1234-2003X17740128, dated 3/23/2003). The contractor maintains an accounting system on the accrual basis in accordance with generally accepted accounting practices. The contractor's procedures (Permanent file, Folder A) include (1) maintaining a chart of accounts in which specific accounts have been established for accumulating unallowable costs and directly associated costs (W/P B-2a) and (2) procedures for excluding these costs from billings and claims to the Government.

ABC's indirect pools and bases established to accumulate and allocate indirect costs are as identified in its incurred cost claim on W/P 22, Schedule A and supporting schedules, and consistent with its established procedures (Contractor permanent file, Folder B). The contractor has not identified any significant accounting changes (W/P 22, Schedule M).

√	Maximum Control Risk
Control risk is assessed at maximum because (i) it is more efficient to perform substantive testing than perform tests of internal controls or (ii) the internal controls are ineffective or nonexistent.	

□	Below Maximum Control Risk
<i>(Control risk can only be assessed below maximum if significant internal controls applicable to the CFY being audited have been reviewed and sufficiently tested for operational effectiveness. If control risk is assessed below maximum, document/reference below the audit assignment where the tests of controls were performed that supports the assessment.)</i>	

B-2 (1/1)

Auditor:	
Date:	

Enclosure 2